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SUBJECT: Direct Sales in South China: Still Waiting for the Day

REF: 05 Guangzhou 23964

(U) This message is sensitive but unclassified. Please handle accordingly.

1. (SBU) Summary: U.S. direct sales companies in Guangzhou are optimistic that the China market is once again becoming hospitable to them. A new law issued in December 2005, and a batch of licenses expected for summer 2006, has brought direct selling out of the hybrid retail model in which it was forced to operate since 1998. Nevertheless, companies will not be content until the government allows "real" direct selling, which to them means multi-level marketing. As it currently stands, companies are not permitted to implement the multi-level, team-based model that they use in most other countries. The upcoming year will be a period of wait-and-see, as national and local regulators form a workable system. End summary.

2. (SBU) Econoff spoke with Amway's Steven Cheng, chief financial officer for the greater China region; Nu Skin's Ky Eap, sales director for southern China; and Sunrider's Patrick Lam, director of art and communications for China, about the state of South China's direct sales industry. Avon, the only company to have a direct sales license at the moment, declined our request for a meeting.

Background on Direct Sales and the Companies  
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3. (SBU) China first opened the direct sales sector in the late 1980s. A proliferation of pyramid schemes and fraudulent activity, largely by domestic entities, caused a public uproar in the late 1990s, leading the government to ban direct sales in 1998. However, the government allowed ten large direct sales companies to continue to operate as "change mode companies," but required them to sell from retail outlets in fixed locations in what one representative described as a "hybrid system." The government issued two key regulations on direct selling in 2005 and a new direct sales law in November 2005. (This came late, as China agreed to open the direct sales sector by December 2004 in its WTO accession agreement.) Avon received the first license to operate in February 2006. Amway, Nu Skin, and Sunrider all expect to receive licenses this summer.

¶4. (SBU) The aforementioned companies all sell personal care products and health supplements, and all of them manufacture in China. Amway is the largest of the direct sellers, with RMB 17 billion (USD 2.1 billion) in sales in China in 2004. It has a presence in 150 cities in China. Sunrider, a privately held company, has 14 branch offices in China. The company has operations in 38 countries, but China accounts for 40 percent of its global sales. Nu Skin, with 165 retail stores in China, has approximately USD 150 million in annual sales here. Avon, with whom we have met in the past, has 74 branch offices and had USD 220 million in sales in China in 2004.

#### The 2005 Law: Still Not "Real" Direct Sales

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¶5. (SBU) The most pressing concern for Amway, Nu Skin, and Sunrider is the requirement that companies use a single-level marketing (SLM) model. In SLM, only sales agents receive commissions for their sales. Multi-level marketing (MLM), by contrast, is characterized by earnings and bonuses trickling up from salespersons to their team leaders and supervisors. According to Amway, Chinese law explicitly prohibits group remuneration for sales, which is the hallmark of MLM. (Note: After reviewing the text of the December 2005 law, we cannot find wording that bans MLM. However, the accompanying "Regulation on Banning Pyramid Schemes," issued November 2005, includes text that explicitly prohibits sales commissions going to more than one person. End note.)

¶6. (SBU) China's reluctance to institute MLM apparently derives from its bad experience with pyramid schemes. Amway

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said this fear is unfounded, as the two systems are distinct. A pyramid scheme is based upon the number of people recruited, and an agent's income depends on his ability to headhunt. In legitimate MLM, on the other hand, commissions are generated from sale revenue, not recruitment. Amway said 70-80 percent of direct sales companies worldwide use MLM. Nu Skin has a presence in 43 countries, and only in China do they not use MLM. Sunrider said China "does not understand" MLM. Cheng said that China's WTO agreement does not define direct sales as including MLM, thus authorities can now define it by the SLM model.

#### Commission Cap

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¶7. (SBU) The 2005 law limits sales commissions to 30 percent. Sunrider and Nu Skin complained that the 30 percent commission cap falls below the worldwide average, which industry observers have put at a little over 40 percent. Amway, however, said its average worldwide commissions fall between 30 and 35 percent, and does not view the cap as a problem.

#### Service Centers and Branch Offices

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¶8. (SBU) The 2005 direct sales law also requires that companies set up customer service centers in provinces in which they operate. None of the representatives could explain exactly what constitutes a service center under the law. Amway and Nu Skin said it may be as little as a person's residence. Depending on the accepted definition, Nu Skin may end up with 1,000-2,000 service centers in China, many of which will also operate as retail stores. Amway has decided to provide a service function in all of its stores, and will not set up independent service centers.

¶9. (SBU) In addition, the new law requires that a direct sales company have a branch office in every province in

which it operates. The role of branch offices is also not clear, but the representatives said they plan to use them as centers for distribution, training, and after-sales service. Sunrider said it is economically "not feasible" to open a branch office in every province in which it operates, and said the requirement will slow the growth of the industry. Amway, on the other hand, does not see the requirement as a burden, largely because of the company's sizable assets.

#### Group Gatherings and Training

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¶10. (SBU) All of the company representatives said China strictly enforces the requirement that large gatherings be approved beforehand by authorities. The typical limit is 50 people, though the number depends on whether the meetings are held at the provincial, municipal, or local levels. Recruitment drives or team-building events for direct sales companies can easily involve more than 50 people. Amway said there is no way around the requirement, and they simply must be diligent in notifying Chinese authorities. Nu Skin and Sunrider said they typically organize such events in the form of concerts in order to more easily alleviate government concerns.

¶11. (SBU) In addition, the new law states that trainers must be employees of the company -- not consultants, as is the case in many other countries. New sales agents also must take a government-administered exam before their first sale. According to Amway, these requirements allow Chinese authorities to regulate how a company recruits its sales agents and also what the agents are taught.

#### Capitalization Requirement

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¶12. (SBU) The new law attempts to limit the direct sales sector to large, established companies by setting a high entry threshold. Under the law, to establish a direct sales

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entity in China, a company must prove registered capital of at least RMB 80 million (USD 9.9 million) and pay a RMB 20 million (USD 2.5 million) deposit. None of the three companies expressed reservations about this requirement, since they all can easily overcome it. Indeed, they even see it as beneficial, since it limits their competition. Nu Skin said the high threshold prevents small and unscrupulous firms from entering the market and "getting in trouble." Nevertheless, by barring smaller firms, the requirement may unintentionally lead to illegal underground activity, including counterfeiting of legitimate products (reftel).

#### A Transitional Period

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¶13. (SBU) All of the companies described 2006 as a period of transition, during which China's regulators will clarify currently vague areas of the law through public announcements and selective enforcement. According to Amway, the Chinese government will not begin enforcing the new law in earnest until the end of 2006. Nu Skin said the lack of clarity in regards to how a company operates its service centers may be by design, as the Chinese authorities prefer to wait and see where to draw the line. Local regulators are also uncertain how to interpret the law and are using this year to seek guidance from central authorities.

#### Comment

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¶14. (SBU) The last eight years have been difficult for direct sales companies in South China, as they have been operating in a sensitive environment and under a watchful eye. Though direct sales companies consider the current

operating environment less than ideal, they are optimistic that the day will come when MLM is allowed in China. They are all treading carefully for the time being, however, so as not to anger regulators and cause further restrictions. Much will depend on how provincial and local authorities interpret and enforce the new law, particularly after more licenses are issued.

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